FULBRIGHT BRIEFING - PUBLIC FINANCE

Navigating the Stimulus Legislation's New Municipal Bond Provisions

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I. Introduction

The American Recovery and Reinvestment Tax Act of 2009 (the "**Stimulus Act**"), signed into law by President Obama on February 17, 2009, contains a number of significant provisions intended to enhance the terms on which state and local governments may issue municipal bonds for governmental purposes and to finance projects for conduit borrowers. This article is intended both to summarize these provisions and to identify practical issues that should be taken into account in taking advantage of them.

The Stimulus Act provides new authority to issue tax credit bonds and federally subsidized taxable bonds, both called "**build America bonds**" or "**BABs**," in 2009 and 2010 only, for governmental projects. The authority is intended to provide, respectively, approximately 25% and 35% federal subsidies of the issuer's taxable borrowing rate, and a 45% subsidy for certain BABs issued to promote economic development in distressed "recovery zones." The Stimulus Act also authorizes limited amounts of (1) substantially interest-free tax credit bonds (of limited term) for public school construction, repair, and rehabilitation and (2) additional interest-free or reduced-rate tax credit bonds (also of limited term) for public qualified zone academies, clean renewable energy facilities, and energy conservation programs. In addition, the Stimulus Act authorizes (1) limited amounts of tax-exempt bonds to finance privately owned facilities in recovery zones, (2) limited amounts of tax-exempt bonds to finance privately owned intercity high-speed rail lines, as well as tax-exempt small issue industrial development bonds, in expanded circumstances, and (3) limited amounts of tax-exempt tribal economic development bonds.

To enhance the terms on which currently authorized tax-exempt bonds can be sold, the Stimulus Act (1) permits banks to hold certain tax-exempt bonds issued in 2009 or 2010 in an amount up to 2% of their assets (and expands the eligible "qualified tax-exempt obligations" issued in those years that banks may hold in excess of that amount) and still deduct 80% of their allocable interest-expense, and (2) exempts new-money bonds issued in 2009 and 2010 (and certain refundings) from the alternative minimum tax imposed on individuals and corporations.

These provisions, as well as some of their consequences, are described below. In addition, on April 2 and 6, the United States Treasury Department (the "**Treasury Department**") and the Internal Revenue Service (the "**IRS**") released initial implementation guidance for BABs, as well as volume limitations for qualified school construction bonds, qualified zone academy bonds, and qualified energy conservation bonds, and application procedures for new clean renewable energy bonds. These guidance items are discussed below and are available at http://www.fulbright.com/publications/guidance, and the volume limitations are set forth on Appendix A.

II. Governmental Financing Tools

The Stimulus Act creates important tax-advantaged bond authority for state and local governments for governmental projects and programs. In many cases the authority is intended to provide greater economic benefits to issuers than traditional tax-exempt bonds. The new authority includes bonds for which issuers will receive direct cash subsidy payments from the federal government, or for which bond owners will be entitled to claim federal income tax credits. The new authority for governmental projects and programs is described in this Part II.

A. Build America Bonds (BABs)

1. In General

a. Two Types of BABs

The Stimulus Act creates a new category of state or local government bonds called "**build America bonds**" or "**BABs**" and authorizes them to be issued in 2009 and 2010 only. BABs are taxable bonds intended to provide low-cost financing to state and local governments for governmental purposes as an alternative to governmental, tax-exempt bonds. There are two types of BABs: (1) "**Direct Subsidy BABs**," which entitle the bond issuer to receive cash payments from the federal government equal to 35% of the interest payable on the bonds on each interest payment date (45% in the case of Recovery Zone Economic Development BABs, discussed below); and (2) "**Tax Credit BABs**," which entitle bond owners to claim federal income tax credits equal to 35% of the interest payable on the bonds on each interest payment date (resulting in an estimated net 25% indirect subsidy of an issuer's taxable bond yield).

b. Basic Requirements for All BABs

A state or local government issuer may elect to treat a bond as a BAB if the bond:

(1) meets the federal tax requirements applicable to governmental, tax-exempt bonds (including limitations on arbitrage and private business use); and

(2) has an original issue price that does not include original issue premium greater than or equal to the product of (a) one-fourth of one percent (0.25%) of the stated redemption price at maturity, multiplied by (b) the number of complete years to maturity.

Tax-exempt private activity bonds (such as exempt facility bonds, mortgage revenue bonds, qualified small issue bonds, qualified student loan bonds, and qualified 501(c)(3) bonds) are not eligible to be designated as BABs.

There are no volume limitations on BABs. However, as indicated above, BABs may only be issued in 2009 and 2010. Unlike previously authorized qualified tax credit bonds, the only maturity constraints applicable to BABs are those that apply to governmental, tax-exempt bonds, *i.e.*, that they comply with the safe harbor for capital projects (under which the weighted average maturity of the bonds may not exceed 120% of the expected economic life of the property being financed) or otherwise avoid replacement proceeds or anti-abuse consequences.

2. Direct Subsidy BABs

a. Eligible Purposes

An issuer may designate a BAB as a Direct Subsidy BAB if 100% of (a) the "available project proceeds" of the issue of which the BAB is a part less (b) any amounts in a reasonably required reserve fund are to be used "for" capital expenditures. For this purpose, "**available project proceeds**" consist of (1) the proceeds from the sale of the issue, minus (2) the amount of any issuance costs financed by the issue to the extent such costs do not exceed 2% of such proceeds, plus (3) any earnings derived from investing such proceeds. In general, Direct Subsidy BABs must be new-money bonds issued to finance capital (as opposed to working capital) expenditures. Refunding bonds are not eligible for designation as Direct Subsidy BABs. However, as discussed under "Capital Expenditure Requirement" at page 3 below, short-term obligations issued after February 17, 2009, to finance capital expenditures paid or incurred after that date may be refinanced with Direct Subsidy BABs if certain requirements in the reimbursement rules applicable to tax-exempt bonds are met.

b. Direct Subsidy Payments

Interest on Direct Subsidy BABs is taxable to the bond owners. Unlike Tax Credit BABs, the owners of Direct Subsidy BABs are not entitled to tax credits. Rather, if an issuer designates a BAB as a Direct Subsidy BAB, then the issuer (or any person making interest payments on the issuer's behalf, such as a bond trustee) will be entitled to receive from the Treasury Department, "contemporaneously" with each interest payment date throughout the entire term of the bond, a cash payment equal to 35% of the interest payable on the bond on that date. (For a type of Direct Subsidy BAB that may qualify for a 45% subsidy, see "Recovery Zone Economic Development BABs" at page 6 below.) Since state and local government issuers are exempt from federal income tax, their benefit from the 35% subsidy is not reduced by the tax burden, as is the case for Tax Credit BABs. The Stimulus Act does not define "contemporaneous" for this purpose, although the legislative history indicates that the payments may be made either in advance or as reimbursement. For a description of interim payment terms, see "Procedures for Electing and Receiving Federal Subsidy and Credit" at page 8 below.

c. Capital Expenditure Requirement

As indicated above, 100% of the available project proceeds of Direct Subsidy BABs (less amounts in a reasonably required reserve fund) are "to be used" for "capital expenditures." For this purpose, the tests applicable to tax-exempt bonds will be applied to determine whether a reserve fund is reasonably required.

The inclusion of earnings on bond proceeds in the amount that must be expended for capital expenditures raises at least two issues which, hopefully, will be resolved by guidance. First, are earnings netted for arbitrage rebate liability? That would seem sensible and fair, but is not clearly addressed by the Stimulus Act or the provisions of Section 54A of the Internal Revenue Code (the "**Code**"), to which it refers. Second, are earnings on deposits to a reasonably required reserve fund included in the base? "Available project proceeds" are defined in Section 54A to include all earnings on proceeds, other than proceeds to finance issuance expense. In computing the amount that must be expended for capital expenditures, available project proceeds are reduced only by amounts "in" a reasonably required reserve fund. If the fund is fully funded, earnings on the fund may not be retained in the fund, so must they also be expended for capital expenditures?

The Stimulus Act legislative history incorporates the definition of "**capital expenditure**" in the tax-exempt bond rules, which generally focuses on whether a cost would be properly chargeable to capital account under general federal income tax principles. Under this definition, for example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. However, there is no single bright-line rule for determining whether a cost is a capital expenditure. Thus, certain types of costs (such as interest costs or employee wages) will need to be reviewed carefully to determine eligibility for financing with Direct Subsidy BABs. Since costs of issuance are not capital expenditures, and proceeds to pay costs of issuance are exempt from the capital expenditure requirement only up to 2% of the issue price of the bond issue, the amount of costs of issuance that may be financed by the issue is effectively capped at this amount. Notice 2009-26 clarifies that proceeds are to be used for capital expenditures if used (1) to reimburse capital expenditures in accordance with the reimbursement rules in Treasury Regulations § 1.150-2 applicable to tax-exempt bonds, even if paid or incurred before the effective date of the Stimulus Act (February 17, 2009), or (2) to redeem temporary short-term obligations (*e.g.*, commercial paper) issued after February 17, 2009, to finance capital expenditures paid or incurred after that date if certain requirements of Treasury Regulations § 1.150-2 are met. Unlike the prior authority for qualified tax credit bonds, the Stimulus Act does not provide a time by which net available project proceeds are to be used for capital expenditures. See also "Miscellaneous Considerations Applicable to BABs--Remedial Action" at page 10 below.

d. Non-payment Risk

The 35% interest subsidy payable by the federal government to an issuer of Direct Subsidy BABs constitutes a tax credit that, in federal income tax parlance, is "refundable," in that it is required to be paid without regard to any tax liability of the bond owners or the issuer. It is possible (however remote that possibility may be) that in the future Congress could repeal or reduce the 35% subsidy. Issuers of Direct Subsidy BABs generally would bear this risk. By contrast, in the case of fixed-rate tax-exempt bonds, the risk that Congress could eliminate or reduce the value of the tax exemption in the future is generally borne by the bond owners.

e. Tax Opinion Considerations

Unlike buyers of tax-exempt bonds and tax credit bonds, purchasers of Direct Subsidy BABs are not expected to require a tax opinion (except possibly if the 35% interest subsidy is material to the issuer's ability to pay the bonds), because Direct Subsidy BABs will not provide a federal tax benefit to bond owners. Issuers of Direct Subsidy BABs will likely request legal advice regarding their eligibility for the subsidy. It is not yet certain, however, whether issuers will require an "unqualified" tax opinion, or whether they may be willing to accept advice at a lower level of certainty, such as "more likely than not," and rely in part on the improbability of being audited. See also "Circular 230" at page 32 below.

f. Relationship Between Issuers and IRS

In the event of an examination by the IRS of an issue of Direct Subsidy BABs, the relationship between the IRS and the issuer may be fundamentally different from that relationship in a tax-exempt bond examination. The existence of the direct subsidy payments from the Treasury Department to the issuer raises a number of procedural issues. Although the procedures applicable to taxpayers who make tax overpayments will apply to issuers of Direct Subsidy BABs, additional Treasury Department guidance may be needed to provide procedural protections to issuers in the event of a dispute with the IRS. Since the federal subsidy could be terminated without locating and assessing innocent bondholders or tax credit holders, it is possible that the IRS could be more aggressive in resolving disputes over Direct Subsidy BABs than over tax-exempt bond compliance.

g. Pledges of Interest Subsidy

In some circumstances, issuers may wish to pledge their interests in the federal interest subsidy to bondholders to enhance the credit supporting their bonds. If the subsidy were to be pledged as security for tax-exempt bonds (and possibly Direct Subsidy BABs), absent guidance from the Treasury Department the pledge could result in the bonds being characterized as "federally guaranteed" obligations under section 149(b) of the Code and, therefore, taxable. Accordingly, issuers should be careful in making pledges that could secure parity bonds. The Stimulus Act provides that BABs are not federally guaranteed "by reason of" the federal subsidy, which could be based on the fact that a payment to the issuer could be accessed by and diluted by the existence of other creditors, so it is not the equivalent of a guaranty of debt service on specific bonds. However, an enforceable pledge of the subsidy as security for specific bonds might be viewed differently. In addition, to pledge federal interest subsidy revenue, issuers would need to satisfy themselves that state law authorizes a pledge of the revenue. In the case of revenue bond issuers, the interest subsidy could be viewed as revenue from the ownership of the utility system property being financed by the BABs, since the subsidy is conditioned on capital expenditures for the property. In the case of bonds supported only by a pledge of property taxes or other tax revenue, authority for a pledge of the federal interest subsidy may be harder to find. Since the interest subsidy is due "contemporaneously" with interest, the legislative history of the Stimulus Act contemplates federal payments to "reimburse" interest payments, and Notice 2009-26 indicates that for the known future interest payments will be made by U.S. mail, issuers likely cannot rely on the federal subsidy to make interest payments in any event, unless they establish a debt service reserve fund in the amount of the maximum interest subsidy installment. Finally, it may be difficult to perfect a pledge of the interest subsidy consistently with the Assignment of Claims Act of 1986, 31 U.S.C § 3727, absent Treasury Department guidance to allow and issue warrants for claims to the subsidy. Accordingly, while federal interest subsidies may enhance the creditworthiness of issuers, they may not otherwise add practical security for Direct Subsidy BABs or other bonds.

3. Recovery Zone Economic Development BABs

a. Authorization

The Stimulus Act authorizes a special category of BABs called "recovery zone economic development bonds" ("**Recovery Zone Economic Development BABs**"). They may be issued in 2009 or 2010 by counties and "**large municipalities**" (population in excess of 100,000) to promote economic activity in a "recovery zone." They are entitled to a 45% interest subsidy, rather than the 35% subsidy for Direct Subsidy BABs. Recovery Zone Economic Development BABs are subject to a cumulative total nationwide volume cap of $10 billion.

b. Basic Requirements for Designation

A county or large municipality may designate BABs as "**Recovery Zone Economic Development BABs**" if (1) 100% of the "available project proceeds" of the issue of which they are a part, other than any amounts in a reasonably required reserve fund, are to be used for one or more "qualified economic development purposes" and (2) the issue is allocated an equal amount of the cumulative total nationwide $10 billion cap on such bonds. Recovery Zone Economic Development BABs must satisfy the conditions for BABs generally, but need not satisfy those for Direct Subsidy BABs, even though they are entitled to a direct federal interest subsidy.

A "**qualified economic development purpose**" is an expenditure for the purpose of promoting development or other economic activity in a recovery zone, including:

(1) capital expenditures paid or incurred with respect to property located in the zone;

(2) expenditures for public infrastructure and construction of public facilities; and

(3) expenditures for job training and educational programs.

A "**recovery zone**" is:

(1) any area designated by the issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress;

(2) any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990; and

(3) any area for which a designation under federal law as an empowerment zone or renewal community is in effect.[1]

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[1] There are currently 40 empowerment zones and 40 renewal communities that have been designated by the federal government based on nominations of distressed geographic areas by state and local governments. A variety of federal tax benefits are available to businesses in these areas. The Department of Housing and Urban Development designated 30 of the empowerment zones and all 40 of the renewal communities. The Department of Agriculture

Unlike regular Direct Subsidy BABs, Recovery Zone Economic Development BABs may finance working capital expenditures, provided those expenditures promote development or other economic activity in a recovery zone. In addition, absent guidance to the contrary, property financed by a Recovery Zone Economic Development BAB does not appear to need to be located in a recovery zone of the issuer, if it promotes development or other economic activity in a recovery zone, nor does the property or recovery zone appear to be required to be located within the jurisdiction of the issuer. However, since the amount of such bonds is capped by allocations to issuer jurisdictions, as a practical matter issuers would appear to be unlikely to finance property located outside their jurisdiction. Expenditures to acquire (even without improving) property in a recovery zone would appear to be eligible, if the acquisition is made to promote development or other economic activity in the zone, *e.g.*, to transfer ownership to a creditworthy owner which will preserve employment at the property.

c. Volume Cap Allocations

The Stimulus Act requires the Treasury Department to allocate the cumulative nationwide cap for Recovery Zone Economic Development BABs among the states on the basis of their respective employment declines for 2008 (except that a minimum allocation of $90 million is provided for each state). (Because the allocations are based on absolute job loss rather than a decline in the unemployment rate, states with declining work-age populations are favored, and states with increasing work-age populations are more likely to receive the minimum allocation, which is not weighted by population.) Each state, in turn, is required to reallocate its cap among the counties and large municipalities in the state on the basis of the respective 2008 employment declines in those municipalities and the areas of the counties outside those municipalities. The Stimulus Act provides that municipalities and counties may waive their allocations, but does not clearly provide for reallocation of waived allocations of the cap. Consequently, it is not clear whether states may reallocate returned cap other than in proportion to job loss. The Stimulus Act does not state how or when the Treasury Department is to determine employment declines by state, or how employment declines within states are to be determined if the method elected to be used by the Treasury Department cannot be applied within a state (for example to determine employment decline in the unincorporated area of a county that includes part of a large municipality).

4. Tax Credit BABs

a. Eligible Purposes

A BAB is treated as a Tax Credit BAB unless it meets the requirements for, and the issuer designates it as, a regular Direct Subsidy BAB or Recovery Zone Economic Development BAB, as discussed above. State or local governments may issue Tax Credit BABs for any purpose for which governmental, tax-exempt bonds may be issued under federal tax law. Thus, Tax Credit BABs may be issued for new-money purposes to finance capital and limited working capital expenditures, and they may also be issued for current or advance refunding purposes, subject in each case to arbitrage, private business use, and other applicable tax limitations.

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designated the remaining 10 empowerment zones. The empowerment zone and renewal community designations expire after 2009. The effect of this expiration is not entirely clear with respect to bonds authorized by the Stimulus Act for the benefit of recovery zones.

b. Non-refundable Credit

Interest on a Tax Credit BAB is includible in gross income for federal income tax purposes. However, the owner of a Tax Credit BAB may claim a federal income tax credit equal to 35% of the interest payable on the bond on each interest payment date, to the extent of its tax liability. For a description of the federal income tax consequences of and limitations on the tax credit, see " Tax Credit Bond Features -- Non-refundable Credit" at page 21 below.

c. Interest Subsidy to Issuers

As explained in the Stimulus Act legislative history, Tax Credit BABs are intended to enable an issuer to borrow at an interest rate approximately equal to 74.1% of its taxable borrowing rate. The premise underlying this conclusion is that an interest rate of 74.1% of the issuer's taxable rate, combined with a taxable tax credit equal to 35% of 74.1%, or 25.9%, of the issuer's taxable rate, is approximately equal in value to 100% of the issuer's taxable borrowing rate. In other words, since a tax credit is the equivalent of an additional cash payment (to the extent of the holder's tax liability), investors are expected to accept an interest rate payable by the issuer at a lower rate if they also receive the tax credit. To the extent bond purchasers view the tax credits as less valuable than cash, however, the interest rate on Tax Credit BABs would likely exceed 74.1% of the issuer's taxable borrowing rate. In addition, many issuers may not be able to issue taxable bonds as efficiently as tax-exempt bonds. See "Considerations Applicable to Taxable Bonds and Tax Credits -- Market for Taxable Bonds" at page 31 below.

d. Credit Stripping

As a potential enhancement of the value of Tax Credit BABs to issuers and bond owners, the Stimulus Act authorizes the Treasury Department to issue regulations under which a Tax Credit BAB and the associated tax credits could be separated (or "**stripped**") and sold separately upon initial issuance or in the secondary market. The stripping provisions are to be "similar" to those authorized for other tax credit bonds. For a description of credit stripping and its consequences, see " Tax Credit Bond Features -- Credit Stripping" at page 21 below.

e. Credit Based on Interest "Payable"

The tax credit for Tax Credit BABs is equal to 35% of the interest "payable" on the bond. The use of the term "payable" rather than "paid" makes clear that a bond owner (or, in the case of a stripped credit, the credit owner) will be entitled to the credit even if the issuer defaults on its interest payment, although in some circumstances a modification of the bonds (including in a proceeding for the adjustment of debt under the federal Bankruptcy Code or state law) could adversely affect the amount of the credit that may be claimed.

5. Procedures for Electing and Receiving Federal Subsidy and Credit

a. Payment Procedures for Direct Subsidy BABs (Including Recovery Zone Economic Development BABs)

To request federal subsidy payments with respect to Direct Subsidy BABs (including Recovery Zone Economic Development BABs), issuers will need to make ongoing filings with the IRS of new "Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds*" ("**Form 8038-CP**"). For fixed rate bonds, issuers will be required to file a separate Form 8038-CP at least 45 (but no more than 90) days before each interest payment date. Notice 2009-26 indicates that the IRS will make a subsidy payment for fixed rate bonds "on a contemporaneous basis" by the applicable interest payment date if the IRS receives a timely filed Form 8038-CP requesting the payment.

For variable rate bonds, issuers will be required to file Form 8038-CP on a quarterly basis. Notice 2009-26 indicates that the IRS will make a subsidy payment for variable rate bonds on a reimbursement basis for interest paid by the issuer during the quarter if the IRS receives a timely filed Form 8038-CP requesting the payment. The due date for filing Form 8038-CP for variable rate bonds is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested. Notice 2009-26 states that issuers should expect to receive requested payments within 45 days after a Form 8038-CP is filed with the IRS.

An issuer is permitted to specify a third party (*e.g.*, the bond trustee) to receive subsidy payments. In those circumstances it will be important to verify that the third party's address on record with the IRS (to which the IRS will send the payments) is correct.

Unless and until the Treasury Department establishes a mechanism for electronic payment of the subsidy, it is expected that subsidy payments will be made by check through the U.S. Postal Service with attendant possible delays in receipt.

According to Notice 2009-26, the IRS will be prepared to accept Forms 8038-CP by May 1, 2009, and will be prepared to make timely payments with respect to interest payment dates beginning on or after July 1, 2009.

b. Information Reporting

Notice 2009-26 contains special instructions for Direct Subsidy BABs, Recovery Zone Economic Development BABs, and Tax Credit BABs with respect to "Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations*" ("**Form 8038-G**"), which issuers of these bonds are required to file with the IRS. Issuers must file Form 8038-G at least 30 days before the first Form 8038-CP is filed, except that, for bonds issued before July 1, 2009, the Form 8038-G may be filed any time before the first Form 8038-CP is filed.

c. Elections

Notice 2009-26 indicates that the irrevocable election that an issuer must make to designate a bond as a Direct Subsidy BAB, a Recovery Zone Economic Development BAB, or a Tax Credit BAB is to be made on the issuer's books and records on or before the issue date of the bonds. Accordingly, an election contained in the issuer's "no arbitrage" or other tax certificate will be adequate, if retained as part of the transcript of proceedings for BABs in the issuer's records.

d. IRS Request for Comments

In Notice 2009-26, the Treasury Department and the IRS have requested comments from the public on the payment procedures for Direct Subsidy BABs and Recovery Zone Economic Development BABs, including comments regarding efficient methods to make the payments, workability and ease of usage for state and local governments, ongoing compliance safeguards, and the tax procedural framework for the payments. The Notice indicates that the IRS and Treasury Department plan to study the feasibility of using an "electronic platform" similar to the one used to make payments on State and Local Government Series securities and requiring issuers to file information returns at least annually.

6. Miscellaneous Considerations Applicable to BABs

a. Base for Federal Subsidy or Credit

The legislative history of the Stimulus Bill and Notice 2009-26 clarify that original issue discount is not treated as interest eligible for the federal tax credit or direct subsidy. Consequently, only periodic interest payable by the issuer receives the federal subsidy. Accordingly, by analogy, credit enhancement fees and payments on qualified interest rate hedges would not appear to qualify for the subsidy, absent Treasury Department guidance.

b. Arbitrage Yield

As indicated above, BABs are generally subject to the arbitrage restrictions on investing bond proceeds and the arbitrage rebate requirements that apply to tax-exempt bonds. In determining the applicable "allowable" yield for these purposes, yield is viewed from the standpoint of the issuer, not the investor. Accordingly, for these purposes, the tax credit allowed to Tax Credit BAB owners is disregarded in determining the yield on the Tax Credit BABs. Thus, in general, the applicable arbitrage yield for Tax Credit BABs is the taxable bond yield. As described above, it is expected that the taxable bond yield will be reduced to a rate comparable to a tax-exempt rate as a result of the tax credit. In the case of Direct Subsidy BABs (including Recovery Zone Economic Development BABs), the cash payments received by the issuer from the federal government are taken into account in determining the arbitrage yield. Thus, with respect to such BABs, the issuer's gross interest expense is reduced by its federal subsidy in computing the arbitrage yield (potentially increasing arbitrage rebate payments). Since arbitrage limitations made applicable to BABs result from a requirement that the bonds would be tax-exempt if not designated as BABs, the arbitrage yield should be adjusted to take into account fees for bond insurance and other "qualified guarantees," just as for tax-exempt bonds.

c. Remedial Action

As indicated above, BABs are subject to the limitations on private business use or payments that apply to governmental, tax-exempt bonds. Violation of these limitations could cause a retroactive loss of tax credits to owners of Tax Credit BABs or stripped credits, or could require an issuer of Direct Subsidy BABs to return its cash subsidy payments to the federal government. It appears that the regulatory tax-exempt bond "remedial action" provisions would be available to issuers of Tax Credit BABs or Direct Subsidy BABs to cure certain violations of the private business use and private payment limitations. To preserve an issuer's ability to take a "redemption or defeasance" remedial action with respect to an issue of BABs, the BABs would have to be payable or callable by the issuer within 10.5 years after their issuance, which may have adverse consequences in the market for taxable bonds and tax credits. Absent guidance, it is not entirely clear that the regulatory remedial action provisions would be available for a failure to use 100% of the available project proceeds of Direct Subsidy BABs for capital expenditures or of Recovery Zone Economic Development BABs for qualified economic development purposes. However, in at least one other context, Treasury guidance applicable to bonds subject to the same "are to be used for" language that applies to Direct Subsidy BABs indicates that remedial actions similar to those applicable to tax-exempt bonds are available.[2] It is reasonable to expect that any Treasury Department guidance addressing this issue with respect to Direct Subsidy BABs and Recovery Zone Economic Development BABs would reach a similar conclusion.

d. State Tax Treatment of Interest

The Stimulus Act provides that the interest on a BAB and any associated tax credit are treated as being exempt from federal income tax for purposes of a state's income tax law, except as otherwise provided by the state after the date of enactment. Thus, if these provisions are given effect and not overridden, BABs generally would have substantially the same state tax consequences as federally tax-exempt obligations under the income tax laws of those states in which the state interest exemption for municipal obligations depends on the federal exemption. However, it is questionable whether the Stimulus Act can effectively amend state income tax laws that may dictate a contrary result, since it is not clear that the federal government has power to restrict the levy of taxes by state governments, even for a temporary period.

e. Other Requirements and Considerations

For other requirements and considerations applicable to Direct Subsidy BABs, Recovery Zone Economic Development BABS, and Tax Credit BABs, see "Considerations Applicable to Taxable Bonds and Tax Credits" at page 30 below.

B. Qualified School Construction Bonds

1. New Authorization

The Stimulus Act authorizes the issuance of a new category of "qualified tax credit bonds" for public school construction, rehabilitation, and repair called "Qualified School Construction Bonds." (The characteristics of qualified tax credit bonds are discussed in detail under "Tax Credit Bond Features" beginning on page 19 below.) The Stimulus Act provides a total nationwide volume cap for these bonds of $11 billion for each of 2009 and 2010. No volume cap is authorized for subsequent years, although unused volume cap may be carried forward to future years. The tax credit to which holders of these bonds will be entitled is intended to provide for substantially interest-free borrowing by issuers, but for limited terms.

[2] Prop. Treas. Reg. § 1.1397E-1(h)(7) (relating to qualified zone academy bonds that are not "qualified tax credit bonds" (discussed below) and expressly permitting reliance by issuers notwithstanding proposed status of regulations).

2. Basic Requirements for Designation

An issuer may designate bonds as "**Qualified School Construction Bonds**" if: (1) the issuer receives a volume cap allocation equal to the amount of the bonds; (2) 100% of the "available project proceeds" (as defined on page 22 below) of the issue of which the bonds are a part are to be used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed with part of the proceeds of the issue; and (3) the public school is located in the jurisdiction of the issuer. Notice 2009-35 clarifies that the cost of acquiring equipment to be used in a public school facility being constructed, rehabilitated, or repaired with Qualified School Construction Bonds is eligible for financing with those bonds.

3. Eligible Issuers

Issuers eligible to designate bonds as Qualified School Construction Bonds include a State or any political subdivision thereof (*e.g.*, a public school district), the District of Columbia, any possession of the United States,[3] and an Indian tribal government. Notice 2009-35 clarifies that conduit issuers may issue Qualified School Construction Bonds on behalf of a governmental unit, if the public school to be financed is within the jurisdiction of both the unit and the conduit issuer, and the unit allocates to the conduit issuer a portion of the unit's cap.

4. Volume Cap Allocations

For each of 2009 and 2010 and except as described below, the $11 billion nationwide volume cap generally will be allocated by the Treasury Department among the States and possessions on a preliminary basis in proportion to the respective amounts each is eligible to receive under section 1124 of the Elementary and Secondary Education Act of 1965 for the most recently ended federal fiscal year.[4] However, 40% of the volume cap for each year is to be allocated by the Treasury Department directly among "large local educational agencies" in proportion to the respective amounts each such agency received under section 1124 for the most recently ended federal fiscal year. A State's allocation will be reduced by the total allocations to large local educational agencies in the State. Any volume cap allocated to a State or possession is to be allocated by it to issuers in that State or possession. No limitations or standards are imposed for these allocations by States or possessions, which could allocate additional cap to large local educational agencies. A large local educational agency that receives an allocation may reallocate it to the State or possession in which it is located for reallocation to other issuers. (For issues regarding state allocations of the cap, see "Tax Credit Bond Features -- Volume Cap Allocations" at page 23 below.)

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[3] Notice 2009-35 identifies the following as possessions of the United States for these purposes (and refers to them as "territories"): American Samoa, Guam, Northern Marianas, Puerto Rico, and the Virgin Islands.

[4] The Elementary and Secondary Education Act of 1965 (known as the "No Child Left Behind Act" as re-enacted in 2002) generally provides grants to local education agencies that have more than 10 (comprising at least 2% of their enrollment of) students from families below (or, in certain circumstances, near) the poverty line or in institutions for neglected and delinquent children or correctional institutions. The grants are generally equal to 40% of the state average per-pupil expenditure for education in the state (but not more than 48% nor less than 32% of the national average) multiplied by the number of such students. Accordingly, states that spend more per pupil will receive larger cap allocations per qualified student than those that spend less per pupil.

For these purposes, a "**large local educational agency**" is a local educational agency that is (1) among the 100 local educational agencies with the largest numbers of children aged 5 through 17 from families below the poverty line as determined by the Treasury Department, or (2) one of not more than 25 other local educational agencies determined by the Secretary of Education to be in particular need of assistance. (According to Notice 2009-35, the Secretary of Education has declined to determine any large local educational agencies for 2009 issues under clause (2).)

Before any allocation to the States, a special allocation of the $11 billion volume cap is to be made for each of 2009 and 2010 to the United States possessions (other than Puerto Rico) based on their respective populations of individuals below the poverty line. The remaining nationwide cap is then to be allocated among the States, the District of Columbia and Puerto Rico as discussed above.

Notice 2009-35 specifies the allocations to large local educational agencies, states, and other federal units for 2009. These allocations are set forth in Appendix A on page A-3. In addition to the $11 billion nationwide caps, $200 million for each of 2009 and 2010 is available for allocation by the Secretary of the Interior to Indian tribal governments for the construction, rehabilitation, and repair of schools funded by the Bureau of Indian Affairs. State and tribal volume caps that are not used in a year are carried forward to the following year.

5. Private Business Use and Payments

Although Qualified School Construction Bonds may only be issued to finance public school facilities, they are not subject to the limits on private business use or payments that apply to tax-exempt bonds. Thus, for example, a contract with a private entity to manage all or a portion of the school facility would not have to comply with IRS management contract guidelines for tax-exempt bonds.

6. Other Requirements and Considerations

For other requirements and considerations applicable to Qualified School Construction Bonds, see "Tax Credit Bond Features" at page 19 below and "Considerations Applicable to Taxable Bonds and Tax Credits" at page 30 below.

C. Expanded Tax Credit Bond Authorizations

The Stimulus Act significantly increases volume caps for "Qualified Zone Academy Bonds," "New Clean Renewable Energy Bonds," and "Qualified Energy Conservation Bonds," which are "qualified tax credit bonds" authorized to finance, respectively, public school renovation, renewable energy facilities, and energy conservation projects. Specific requirements applicable to these bonds are discussed below in this Part II.C. The general features of qualified tax credit bonds are discussed under "Tax Credit Bond Features" at page 19 below. The tax credit to which holders of these bonds are entitled is intended to provide for substantially interest-free or low-interest borrowing by issuers, but for limited terms.

1. Qualified Zone Academy Bonds

a. Volume Cap Increase

Although qualified zone academy bonds (or "**QZABs**") have been authorized since 1997, QZABs first became subject to the rules for qualified tax credit bonds as part of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 ("**TEAMTRA**"), enacted on October 3, 2008, and effective for obligations issued after that date. TEAMTRA provided a total nationwide authority for QZABs of $400 million for each of 2008 and 2009. The Stimulus Act adds additional QZAB volume cap of $1 billion for 2009 (for a total of $1.4 billion for 2009) and $1.4 billion for 2010.

b. Basic Requirements for Designation

An issuer may designate bonds as QZABs if: (1) the issuer receives a volume cap allocation equal to the amount of the bonds; (2) 100% of the "available project proceeds" (as defined on page 22 below) of the issue of which the bonds are a part are to be used for a "qualified purpose" with respect to a "qualified zone academy" established by a local educational agency as defined in section 9101 of the Elementary and Secondary Education Act of 1965 (an "**eligible local education agency**"); (3) the qualified zone academy is located in the jurisdiction of the issuer; (4) the issuer certifies that it has written assurances that the private business contribution requirement will be met with respect to the qualified zone academy; and (5) the issuer certifies that it has the written approval of the eligible local education agency for the bond issuance.

c. Qualified Zone Academy

In general, a school is a "**qualified zone academy**" if (1) it is a public school that provides pre-college education, (2) it operates a program designed in cooperation with business to enhance the academic curriculum and increase graduation and employment rates, and (3) either the school is located in an empowerment zone or enterprise community, or there is a reasonable expectation that at least 35% of the students at the school will be eligible for free or reduced-cost lunches under the federal school lunch program.

d. Qualified Purpose

A "**qualified purpose**" is (1) rehabilitating or repairing the school facility in which the academy is established, (2) providing equipment for use at the academy, (3) developing course materials for education to be provided at the academy, and (4) training teachers and other school personnel in the academy.

e. Private Business Contribution Requirement

In general, the "**private business contribution**" requirement is met if the eligible local education agency that established the qualified zone academy has written commitments from private entities to make contributions that meet certain criteria and have a present value at least equal to 10% of the proceeds of the bond issue.

f. Volume Cap Allocations

As under prior law, the Treasury Department is to allocate the QZAB volume cap among the States (including the District of Columbia and possessions of the United States[5]) on the basis of their respective populations of individuals below the poverty line. Volume cap received by a State is to be allocated by the State education agency to qualified zone academies in the State. States generally may carry forward unused QZAB volume cap for up to two years. Notice 2009-30 specifies the allocations to States and other federal units for 2008 and 2009. These allocations are set forth in Appendix A on page A-8.

g. Private Business Use and Payments

Although Qualified Zone Academy Bonds may only be issued to finance public school facilities, they are not subject to the limits on private business use or payments that apply to tax-exempt bonds. Thus, for example, a contract with a private entity to manage all or a portion of the school facility would not have to comply with IRS management contract guidelines for tax-exempt bonds.

h. Other Requirements and Considerations

For other requirements and considerations applicable to Qualified Zone Academy Bonds, see "Tax Credit Bond Features" at page 19 below and "Considerations Applicable to Taxable Bonds and Tax Credits" at page 30 below.

2. New Clean Renewable Energy Bonds

a. Volume Cap Increase

The Energy Improvement and Extension Act of 2008 ("**EIEA**"), enacted on October 3, 2008, created a new type of qualified tax credit bond for renewable energy facilities called "New Clean Renewable Energy Bonds" ("**New CREBs**").[6] EIEA authorized $800 million of total cumulative nationwide volume cap for New CREBs. The Stimulus Act adds an additional $1.6 billion, for a total cumulative nationwide volume cap of $2.4 billion.

b. Basic Requirements for Designation

An issuer that is a "qualified issuer" may designate bonds as New CREBs if: (1) the issuer receives a volume cap allocation from the IRS equal to the amount of the bonds; and (2) 100% of the "available project proceeds" (as defined on page 22 below) of the issue of which the bonds are a part are to be used for capital expenditures for one or more "qualified renewable energy facilities," which are incurred by (a) a State, the District of Columbia, any possession of the United States, an Indian tribal government, or any political subdivision thereof (each, a "**governmental body**"); (b) a state utility with a service obligation within the meaning of Section

[5] Notice 2009-30 identifies the following as possessions of the United States for these purposes (and refers to them as "territories"): American Samoa, Guam, Northern Marianas, Puerto Rico, and the Virgin Islands.
[6] Prior to EIEA, $1.2 billion of "clean renewable energy bonds," or "CREBs," had been authorized. CREBs are subject to similar but not identical program requirements to those applicable to New CREBs.

217 of the Federal Power Act (a "**public power provider**"); or (c) a mutual or cooperative electric company described in section 501(c)(12) or section 1381(a)(2)(C) of the Code (a "**cooperative electric company**").

c. Qualified Issuers

Each of the following entities is a "**qualified issuer**" with respect to New CREBs: (1) a public power provider; (2) a cooperative electric company; (3) a governmental body; (4) a lender (and any affiliated entity controlled by the lender) that is a cooperative and is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002; and (5) a not-for-profit electric utility that has received a loan or loan guarantee under the Rural Electrification Act.

d. Qualified Renewable Energy Facilities

A "**qualified renewable energy facility**" is any of the following renewable energy facilities that is owned by a public power provider, a governmental body, or a cooperative electric company and that meets certain requirements under section 45(d) of the Code: (1) a wind facility; (2) a closed-loop biomass facility; (3) an open-loop biomass facility; (4) a geothermal or solar facility; (5) a small irrigation power facility; (6) a landfill gas facility; (7) a trash combustion facility; (8) a qualified hydropower facility; and (9) a marine and hydrokinetic renewable energy facility.

e. Volume Cap Allocation

Of the total $2.4 billion of New CREBs cumulative nationwide volume cap, $800 million each will be available to governmental bodies (other than public power providers), cooperative electric companies, and public power providers, respectively. To obtain volume cap, issuers will need to apply for and receive an allocation from the IRS. Notice 2009-33 specifies the application procedures and indicates that the application deadline is August 4, 2009. Within each category of governmental bodies and cooperative electric companies, the IRS will allocate the $800 million of available volume cap to projects for which the smallest amount of cap is requested until all the cap for that category is exhausted. (Any amount of clean renewable energy bond volume cap previously allocated to the same project will be treated as an increase in the amount of New CREBs volume cap requested for the project.) For public power providers, the IRS will allocate the $800 million of available volume cap ratably based on the amount requested for each project. Allocations of New CREBs volume cap must be used within three years or they revert back to the IRS for reallocation to other projects.

f. Private Business Use and Payments

Although a facility financed with New CREBs must be owned by a public power provider, a governmental body, or a cooperative electric company, New CREBs are not subject to the limits on private business use and payments that apply to tax-exempt bonds. Thus, for example, a facility financed with New CREBs could be managed by a private company without having to comply with IRS management contract guidelines for tax-exempt bonds. In addition, the facility could be leased to, or the facility's output could be sold to, a private entity without regard to the limits on private business use and private payments applicable to tax-exempt bonds, so long as tax ownership of the facility was not transferred to the lessee or purchaser.

g. Other Requirements and Considerations

For other requirements and considerations applicable to New CREBs, see "Tax Credit Bond Features" at page 19 below and "Considerations Applicable to Taxable Bonds and Tax Credits" at page 30 below.

3. Qualified Energy Conservation Bonds

a. Volume Cap Increase

EIEA authorized a new type of qualified tax credit bonds for energy conservation projects called "**Qualified Energy Conservation Bonds**" with a total cumulative nationwide volume cap of $800 million. The Stimulus Act authorizes an additional $2.4 billion, for a total cumulative nationwide cap of $3.2 billion.

b. Basic Requirements for Designation

An issuer may designate bonds as Qualified Energy Conservation Bonds if: (1) the issuer receives a volume cap allocation equal to the amount of the bonds; and (2) 100% of the "available project proceeds" (as defined on page 22 below) of the issue of which the bonds are a part are to be used for one or more "qualified conservation purposes."

c. Eligible Issuers

Issuers eligible to designate bonds as Qualified Energy Conservation Bonds include a State or any political subdivision thereof, the District of Columbia, any possession of the United States,[7] or an Indian tribal government. Notice 2009-29 clarifies that conduit issuers may issue Qualified Energy Conservation Bonds on behalf of a governmental unit, if the conservation project to be financed is located within or attributable to the jurisdiction of both the unit and the conduit issuer, and the unit allocates to the conduit issuer a portion of the unit's cap.

d. Qualified Conservation Purposes

A "**qualified conservation purpose**" is defined as any item in one of the following five broad categories:

(1) Capital expenditures incurred for purposes of--(a) reducing energy consumption in publicly owned buildings by at least 20 percent; (b) implementing "green community programs" (including the use of loans, grants, or other repayment mechanisms to implement such programs); (c) rural development involving the production of electricity from renewable energy resources; or (d) any of the following renewable energy facilities that meet certain requirements under section 45(d) of the

[7] Notice 2009-29 identifies the following as possessions of the United States for these purposes (and refers to them as "territories"): American Samoa, Guam, Northern Marianas, Puerto Rico, and the Virgin Islands.

Code--(i) a wind facility; (ii) a closed-loop biomass facility; (iii) an open-loop biomass facility; (iv) a geothermal or solar facility; (v) a small irrigation power facility; (vi) a landfill gas facility; (vii) a trash combustion facility; (viii) a qualified hydropower facility; and (ix) a marine and hydrokinetic renewable energy facility;

(2) Expenditures with respect to research facilities, and research grants, to support research in--(a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (c) increasing the efficiency of existing technologies for producing nonfossil fuels; (d) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; or (e) technologies to reduce energy use in buildings;

(3) Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

(4) Demonstration projects designed to promote the commercialization of--(a) "green building technology;" (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak use of electricity; or (e) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and

(5) Public education campaigns to promote energy efficiency.

e. Volume Cap Allocations

The total cumulative nationwide volume cap of $3.2 billion for Qualified Energy Conservation Bonds is to be allocated by the Treasury Department among the States, the District of Columbia, and the possessions of the United States in proportion to their 2008 populations. Each State, in turn, is to allocate a portion of its cap to each "**large local government**" (defined as any county or municipality with a population in excess of 100,000) in the State based on the local government's proportionate share of the State's population. For this purpose, an Indian tribal government is treated as a large local government (without regard to population) located within a State to the extent its population resides in the State. Amounts allocated to a large local government may be reallocated by the local government to the State in which it is located. A State or large local government that receives an allocation may further allocate it to issuers within such State or large local government. Notice 2009-29 specifies the allocations of the $3.2 billion volume cap among the States, the District of Columbia, and the U.S. possessions. (These allocations are set forth in Appendix A on page A-1.) Notice 2009-29 also indicates that, in reallocating portions of their volume cap to large local governments, States are to use data released by the United States Census Bureau as of July 1, 2007.

f. Private Activity Bond Limitations

Up to 30% (but no more than 30%) of the Qualified Energy Conservation Bond volume cap allocated to any State (including the District of Columbia), U.S. possession, or large local government may be used for private activity bonds. For this purpose, any bond issued to provide "loans, grants, or other repayment mechanisms for capital expenditures to implement green community programs" is not treated as a private activity bond. A private activity bond is eligible to be designated as a Qualified Energy Conservation Bond only if 100% of the available project proceeds of the issue of which the bond is a part are to be used for capital expenditures.

g. Additional Limitation Applicable to Indian Tribal Governments

In the case of an issue of Qualified Energy Conservation Bonds issued by an Indian tribal government, the available project proceeds of the issue must be used for an essential governmental function or to finance certain manufacturing facilities.

h. Other Requirements and Considerations

For other requirements and considerations applicable to Qualified Energy Conservation Bonds, see "Tax Credit Bond Features" at page 19 below and "Considerations Applicable to Taxable Bonds and Tax Credits" at page 30 below.

III. Tax Credit Bond Features

A. In General

As indicated above, the Stimulus Act provides authorization for four new types or increased amounts of tax credit bonds--Qualified School Construction Bonds, Qualified Zone Academy Bonds, New CREBS, and Qualified Energy Conservation Bonds--and also authorizes Tax Credit BABs, which have features similar to tax credit bonds. In general, a "**tax credit bond**" is a specialized type of state or local government bond that is designed to provide zero- or low-interest financing for eligible projects. Tax credit bonds have been authorized under the federal tax law in limited amounts and for narrowly defined purposes since 1997. The terms and requirements applicable to different types of tax credit bonds authorized under prior law have not been uniform. The Food, Conservation, and Energy Act of 2008, enacted on May 22, 2008, created a uniform set of terms and requirements that apply to tax credit bonds referred to as "**qualified tax credit bonds**." The tax credit bonds included in the Stimulus Act (other than Tax Credit BABs) are qualified tax credit bonds. Set forth below is a summary of the terms and requirements that apply to qualified tax credit bonds generally and, where indicated, Tax Credit BABs.

B. Tax Credit to Bond Owners

Owners of qualified tax credit bonds are entitled to claim quarterly federal income tax credits based on a credit rate established by the Treasury Department. The "**credit rate**" is the percentage of the principal amount of a bond that may be claimed as a tax credit each year, similar to an interest coupon. It is established for each business day as a fixed rate that applies to any bond sold on that day by any issuer.[8] Accordingly, the credit rate (and, therefore, the dollar

[8] In I.R.S. Notice 2009-15, 2009-6 I.R.B. 449, the Treasury Department indicated that it will determine and announce credit rates daily based on its estimate of the yields on outstanding bonds from market sectors selected by the Treasury Department in its discretion that have an investment grade rating of between A and BBB for bonds of a

credit per bond) is fixed for the term of the bond when the bond is sold. If a bond owner (or, as discussed below, an owner of a detached credit) owns a qualified tax credit bond on any of the following dates ("**credit allowance dates**") or when the bond matures or is redeemed, it may claim a credit against its income tax liability for the tax year in which the date occurs: March 15, June 15, September 15, and December 15. The amount of tax credit for any credit allowance date is equal to 25% of the product of the credit rate multiplied by the principal amount of the bond, *i.e.*, it is one-quarter of the annual tax credit. A ratable portion of the credit is allowed for the first (or last) credit allowance date if the bond is issued (or matures) between credit allowance dates. For a description of the tax credits afforded to Tax Credit BABs, see "Tax Credit BABs -- Non-refundable Credit" at page 8 above.

C. Interest Subsidy to Issuers

For most qualified tax credit bonds, the Treasury Department is directed by statute to establish a credit rate that generally will enable issuers to issue the bonds without discount or interest cost. Thus, most qualified tax credit bonds are designed to provide a 100% interest subsidy to issuers. The credit rate for "New Clean Renewable Energy Bonds" and "Qualified Energy Conservation Bonds" is 70% of that applicable to other qualified tax credit bonds. In practice, the price at which qualified tax credit bonds may be sold, and therefore the actual percentage of any interest subsidy, will likely vary from issuer to issuer due to credit differences and market inefficiencies. For a description of the interest subsidy to issuers of Tax Credit BABs, see "Tax Credit BABs -- Interest Subsidy to Issuers" at page 8 above.

D. Maturity Limits

Tax credit bonds (other than Tax Credit BABs) are subject to specific maturity limitations, which are published by the Treasury Department for each month and applicable to all bonds sold[9] in that month. For qualified tax credit bonds, the maturity limitation is the term the Treasury Department estimates will result in the present value of the obligation to repay the principal being equal to 50% of that principal, based on current interest rates when the bond is sold.[10] For March 2009, for example, the maturity limit was 15 years. This maximum permitted term, combined with the basis for establishing the tax credit to enable the bonds to be sold without discount or interest cost, as described above, is designed to produce an indirect federal subsidy to issuers equal to 50% of the amount of the bonds (and to prevent a greater subsidy by extending the bond term). For example, if an issuer issues at par a $10 million bond that bears no interest, and the present value at the date of issue of the issuer's obligation to repay the bond at maturity is $5 million, then the issuer has received an indirect federal subsidy equal to $5

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similar maturity. Credit rates are published by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at: https://www.treasurydirect.gov.

[9] Although the applicable statutory language for qualified tax credit bonds refers to the month in which bonds are "issued," Notices 2009-29, 2009-30, 2009-33, and 2009-35 clarify that the sale date is the relevant date for determining the maximum maturity of Qualified Energy Conservation Bonds, Qualified Zone Academy Bonds, New Clean Renewable Energy Bonds, and Qualified School Construction Bonds. Maturity limits for qualified tax credit bonds are published by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at: https://www.treasurydirect.gov.

[10] In determining the maturity limits for qualified tax credit bonds, the Treasury Department uses a discount rate equal to 110% of the long-term adjusted applicable federal rate, compounded semi-annually, for the month in which the bond is sold.

million, or 50% of the principal amount of the bond, on a present value basis. As this example illustrates, the economic benefit of a tax credit bond to an issuer increases as the term of the bond increases. To maximize the benefit to the issuer, tax credit bonds are generally issued with a bullet maturity equal to the maximum term, although a bullet maturity is not required.[11] In addition, the higher are prevailing interest rates, the shorter is the permitted term. Issuers desiring longer amortizations may need to combine tax credit bonds with other financing. Qualified tax credit bonds may be refunded at maturity with tax-exempt bonds if the refunding bonds meet the regular requirements applicable to tax-exempt bonds.

E. Non-refundable Credit

The credits from qualified tax credit bonds (and Tax Credit BABs) are treated for federal income tax purposes as if they were payments of taxable interest to the bond owners. Thus, while bond owners (and, as discussed below, holders of stripped credits) may use the credits to offset their tax liability, they must include the credits in gross income. (Any actual interest payments or original issue discount on the bonds also must be included in gross income.) A bond owner may use the tax credit from a qualified tax credit bond (or a Tax Credit BAB) to offset its regular income tax or alternative minimum tax liability. The credit is “non-refundable” in federal income tax parlance in that it is limited to the amount of a bond owner’s tax liability. However, to the extent a bond owner has insufficient tax liability to use the credit for the current year, the bond owner may carry forward the credit to a subsequent year. A bond owner may also sell a qualified tax credit bond (or a Tax Credit BAB) or, as discussed below, the associated tax credits, in a year in which it expects to have insufficient tax liability to use the credit. The sale price presumably would reflect the value of the current and future tax credits.

F. Credit Stripping

The Treasury Department is authorized to issue regulations under which qualified tax credit bonds (and Tax Credit BABs) and the associated tax credits could be separated, or “stripped,” and sold separately upon initial issuance or in the secondary market. In those circumstances, the right to receive bond principal and the right to receive tax credits would each be treated for federal tax purposes as a taxable zero coupon or deep discount bond. The ability to strip the tax credits could enhance the attractiveness of qualified tax credit bonds by enabling an individual bond to be marketed separately to two types of investors: (1) those who have no use for tax credits or otherwise seek taxable debt (such as tax-exempt pension funds, non-profit or public endowments, foreign investors not subject to U.S. income tax, corporations with taxable losses or loss carryforwards or which have maximized their de minimis holdings of tax-exempt bonds, and banks subject to interest expense disallowances); and (2) those that seek to buy a stream of tax credits. Treasury Department personnel have indicated informally that guidance on credit stripping is not likely to be issued before the Fall of 2009. It is expected that this guidance would also apply to credit stripping with respect to Tax Credit BABs, although possibly with some modifications.

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[11] Certain “clean renewable energy bonds” authorized under prior law are subject to a level principal amortization requirement. The level amortization requirement does not apply to “new” clean renewable energy bonds, including those authorized by the Stimulus Act.

To enhance the terms under which qualified tax credit bonds (or Tax Credit BABs) can be sold, issuers likely will want to provide for the post-issuance stripping and separate transfers of tax credits. Stripping cannot safely be accomplished until the Treasury Department promulgates regulations, since neither the tax accounting consequences of stripping nor the procedures required to achieve them are now known. Unlike interest coupons, the tax credit certificates would be in registered form if appertaining to Tax Credit BABs (which must be in registered form) or to comply with stripping regulations that might impose that requirement. For practical considerations in providing for the stripping and separate trading of tax credits, see "Considerations Applicable to Taxable Bonds and Tax Credits -- Separate Trading of Tax Credits" at page 32 below.

G. Reasonable Expectations Requirement for Expenditures

One requirement applicable to an issue of qualified tax credit bonds (but not Tax Credit BABs) is that the issuer must reasonably expect, as of the issue date, that: (1) 100% or more of the available project proceeds of the issue will be spent for one or more qualified purposes within three years after the issue date; and (2) a binding commitment with a third party to spend at least 10% of those available project proceeds will be incurred within six months after the issue date. For this purpose, "**available project proceeds**" consist of (1) the proceeds from the sale of the issue, minus (2) the amount of any issuance costs financed by the issue to the extent such costs do not exceed 2% of such proceeds, plus (3) any earnings derived from investing such proceeds. (Unlike Tax Credit BABs, no allowance is made for proceeds in a reasonably required reserve fund, since no or little debt service is owed annually.) A "**qualified purpose**" is a purpose for which the qualified tax credit bonds in question are permitted to be issued.

H. Redemption Requirement for Unspent Proceeds

To the extent less than 100% of the available project proceeds of an issue of qualified tax credit bonds (but not Tax Credit BABs) are spent for qualified purposes by the end of the "expenditure period," the issuer must redeem an amount of the bonds corresponding to the expenditure shortfall within 90 days after the end of that period. The "**expenditure period**" is the period that begins on the issue date of the bonds and ends on (1) the third anniversary of the issue date or (2) any later date that may be approved by the IRS in response to a private letter ruling request submitted within three years after the issue date if the issuer establishes that the failure to spend the proceeds within three years is due to reasonable cause and the issuer will continue to proceed with due diligence to spend the proceeds for qualified purposes. Since the expenditure requirement for qualified tax credit bonds is based on expectations, rather than actual expenditures, complying with the redemption requirement preserves the tax credit. (As noted above, these provisions do not apply to Tax Credit BABs, where the consequences of failing to spend sufficient proceeds are not entirely clear.) Because investors in taxable bonds historically have been more resistant to call options than investors in tax-exempt bonds, issuers should work with their financial advisors to develop strategies to minimize the pricing impact of any call right included to satisfy this condition of the tax credit.

I. Reimbursement

An issuer may use proceeds of qualified tax credit bonds to reimburse itself for expenditures for qualified purposes paid before the issue date of the bonds if the following requirements are met: (1) the expenditure is paid after the issuer receives a volume cap allocation for the bonds; (2) before it pays the expenditure, the issuer declares its intent to reimburse the expenditure with proceeds of a qualified tax credit bond; (3) no later than 60 days after it pays the expenditure, the issuer adopts a resolution or other "official intent" to reimburse the expenditure with those proceeds; and (4) the bonds are issued and the reimbursement is made no later than 18 months after the expenditure is paid. These reimbursement requirements are more restrictive than those that apply to tax-exempt bonds and previous authorizations of qualified zone academy bonds that are not qualified tax credit bonds. They do not apply to Tax Credit BABs, which are subject to the reimbursement rules applicable to tax-exempt bonds.

J. Arbitrage Limitations

Although qualified tax credit bonds are technically subject to the arbitrage restrictions applicable to tax-exempt bonds, those restrictions are relaxed for qualified tax credit bonds in two important respects. First, investments of available project proceeds are not subject to the arbitrage yield restriction or rebate requirements during the expenditure period described above. Second, an issuer is permitted to establish and retain any earnings from a sinking fund for an issue if (1) the fund is funded no more rapidly than with equal annual installments, in a manner reasonably expected to result in an amount not greater than necessary to repay the issue; and (2) the yield on investments in the fund does not exceed the discount rate used by the Treasury Department to determine the maximum term for the issue. The applicable discount rate used to determine the "allowable" yield is 110% of the long-term adjusted applicable federal rate, compounded semi-annually, for the month in which the issue is sold.[12] As with Tax Credit BABs, the tax credit allowed to bond owners is disregarded in computing the arbitrage yield applicable to qualified tax credit bonds.

K. Volume Cap Allocations

Several provisions of the Stimulus Act require an allocation of state volume caps by "the State" or (in the case of allocations of additional QZAB authority) the "State education agency" to qualify for the tax advantages authorized by the provisions. The Stimulus Act does not expressly provide whether the allocation must be authorized by state law to be effective for federal law purposes. Unless Treasury Department guidance[13] or state law establishes a state officer who is authorized to make allocations on behalf of "the State," state legislation would appear to be required to authorize allocations of the new bond authority. Although the Stimulus Act evidences Congressional intent that its provisions not be delayed by deficiencies in state law[14] (and even if future Treasury Department guidance provides that allocations are effective

[12] See Notices 2009-29, 2009-30, 2009-33, and 2009-35.

[13] Unlike the Tax Reform Act of 1986, which enacted the private activity bond volume cap contained in section 146 of the Code, the Stimulus Act does not provide interim authority to a specific officer. Compare I.R.C. §146(e)(2) (Governors granted interim authority to allocate private activity bond volume cap).

[14] See Stimulus Act §1531(d) (interest on BABs stated to be exempt from state income taxes, absent subsequent state legislation to the contrary).

absent state law authority[15]), unless there is a state law resolution of who speaks for "the State," investors would be subject to the risk of competing allocations, except possibly where the Stimulus Act dictates the amount of allocations by the State to the issuing jurisdictions. Consequently, unless allocation authority is now reposed in a specified state officer or agency, state legislation would appear to be required to enable much of the new capped bond authority to be utilized. Our firm has advised the Governor and Attorney General of Texas regarding such legislation in Texas.

L. "Issue"

For considerations regarding which tax credit bonds comprise the applicable "issue" in applying conditions to the tax credits, see "Considerations Applicable to Taxable Bonds and Tax Credits -- Combining BABs or Qualified Tax Credit Bonds with Tax-exempt Bonds" at page 31 below.

IV. Private Enterprise Financing Tools

A. Recovery Zone Facility Bonds

1. Authorization

The Stimulus Act creates a new category of tax-exempt private activity bonds called "**Recovery Zone Facility Bonds**," which may be issued in 2009 and 2010 by counties and "large municipalities" (population in excess of 100,000) to finance eligible facilities for the benefit of private businesses in "recovery zones" (as defined on page 6 above). In a typical financing structure, Recovery Zone Facility Bonds would be issued by or on behalf of a county or large municipality with the bond proceeds loaned to a conduit borrower. Recovery Zone Facility Bonds are subject to a cumulative total nationwide volume cap of $15 billion.

2. Basic Requirements for Designation

A county or large municipality may designate private activity bonds as "**Recovery Zone Facility Bonds**" if (1) at least 95% of the net proceeds of the issue of which they are a part are to be used for "recovery zone property" and (2) the issue is allocated an equal amount of the cumulative total nationwide $15 billion cap on such bonds.

In general, "**recovery zone property**" is certain depreciable tangible property if:

(1) the property is constructed, reconstructed, renovated, or purchased from an unrelated party by the conduit borrower after the date the recovery zone designation takes effect;

(2) the original use of the property in the recovery zone commences with the conduit borrower; and

[15] Compare Treas. Reg. §5f.103-2(d) (public approval valid regardless of state law authority).

(3) substantially all of the use of the property is in the recovery zone and is in the active conduct of a "qualified business" by the conduit borrower in the zone.

Accordingly, absent guidance to the contrary, acquisitions of previously used property may be financed only if the property is relocated to the recovery zone from outside, and expenditures incurred before the zone is designated may not be reimbursed with bond proceeds, even if "induced" by prior issuer official action.

A "**qualified business**" is any trade or business, with two qualifications. First, it does not include the rental of residential rental property (as defined for purposes of the depreciation rules). Second, it does not include the operation of any of the following facilities: any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Recovery zone facility bonds are generally subject to the provisions of the Code that apply to tax-exempt private activity bonds classified as "exempt facility bonds" (other than certain restrictions on acquiring existing property).

3. Volume Cap Allocations

The Stimulus Act requires the Treasury Department to allocate the cumulative nationwide cap for Recovery Zone Facility Bonds among the states, and requires the states to allocate their cap among large municipalities and counties, on the same basis as for allocating the limitation on Recovery Zone Economic Development BABs. (See "Recovery Zone Economic Development BABs -- Volume Cap Allocations" at page 7 above.) Unlike provisions for allocating the annual volume cap for private activity bonds, the Stimulus Act does not expressly provide for the allocation of a municipality's or county's cap allocation to one of its instrumentalities. In view of Notices 2009-29 and 2009-35, which add conduit issuers to those eligible to issue Qualified Energy Conservation Bonds and Qualified School Construction Bonds, it is reasonable to assume that the Treasury Department will issue similar guidance for Recovery Zone Facility BABs. Unless that further allocation is permitted, many local governments will be unable to make use of their allotted portion of the recovery zone facility volume cap.

B. Qualified Small Issue Bonds for Manufacturing

One type of tax-exempt private activity bond is a "qualified small issue bond" issued to finance a manufacturing facility. Prior to the Stimulus Act, the term "manufacturing facility" was defined, in general, as: (1) a facility that is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of the property); and (2) any facility that is directly related and ancillary to the core manufacturing facility if (a) the "directly related and ancillary" facility is located on the same site as the core manufacturing facility and (b) no more than 25% of the net proceeds of the bond issue is used to provide the "directly related and ancillary" facility. For bonds issued after February 17, 2009, and before 2011, the Stimulus Act modifies the definition of "manufacturing facility" in two respects. First, the Stimulus Act expands the definition of "manufacturing facility" to include a facility that is used in the creation or production of any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar intangible property. Second, the Stimulus Act provides that a facility that is functionally related and subordinate to (and located on the same site as) a manufacturing facility is treated as part of the manufacturing facility regardless of whether the prior law "directly related and ancillary" requirements are met.

C. Exempt Facility Bonds for High-Speed Intercity Rail

High-speed intercity rail facilities are eligible for tax-exempt private activity bond financing. Prior to the Stimulus Act, the term "high-speed intercity rail facilities" was defined as any facility (not including rolling stock) for the fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas using vehicles that are reasonably expected to "operate at speeds in excess of" 150 miles per hour between scheduled stops, but only if such facility will be made available to members of the general public as passengers. The Stimulus Act amends this definition, effective for bonds issued after February 17, 2009, by replacing the requirement that the vehicles be reasonably expected to operate at speeds in excess of 150 miles per hour with a requirement that the vehicles "be capable of attaining a maximum speed in excess of" 150 miles per hour.

V. Tribal Economic Development Bonds

A. Prior law

Prior to the Stimulus Act, bonds issued by Indian tribal governments were eligible for federal tax exemption only if the proceeds were used for essential governmental functions or to finance certain manufacturing facilities.

B. Tax-exempt Bond Authorization

The Stimulus Act expands the ability of Indian tribal governments to issue tax-exempt bonds by authorizing a new type of tax-exempt bond--called "tribal economic development bonds"--with a total nationwide volume cap of $2 billion. An Indian tribal government may designate bonds as "**tribal economic development bonds**" if : (1) it receives from the Treasury Department a portion of the volume cap equal to the amount of the bonds; (2) the bonds would meet all the requirements for federal tax exemption if issued by a state or local government;[16] and (3) the bonds are not part of an issue any portion of the proceeds of which are used to finance (a) any portion of a building in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted or housed or any other property actually used in the conduct of such gaming, or (b) any facility located outside the Indian reservation.

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[16] A tribal economic development bond is treated for federal income tax purposes as if it were issued by a state, and the Indian tribal government issuing the bond (and any instrumentality thereof) is treated as a state for purposes of the private business use limits.

C. Volume Cap Allocations

The Stimulus Act requires the Treasury Department to allocate the $2 billion volume cap among the Indian tribal governments in such manner as the Secretary of the Treasury, in consultation with the Secretary of the Interior, determines appropriate.[17]

VI. Market Enhancement

With a goal of improving the marketability of tax-exempt bonds, the Stimulus Act temporarily relaxes certain restrictions on interest expense deductions applicable to banks that own tax-exempt bonds and provides temporary exceptions to the alternative minimum tax provisions for interest on certain tax-exempt bonds. In addition, the Stimulus Act and prior law contain provisions relating to mutual funds and real estate investment trusts that could enhance the marketability of qualified tax credit bonds and Tax Credit BABs if implemented with Treasury Department guidance. Those provisions are described in this Part VI.

A. Bank Deductibility

1. In General

Banks and certain other financial institutions that own tax-exempt bonds are generally denied a federal income tax deduction for 100% of their interest expense that is allocable to tax-exempt interest. The amount of interest expense allocable to tax-exempt interest is based on the ratio of (1) the average adjusted bases of tax-exempt obligations owned by the financial institution and acquired by it after August 7, 1986, to (2) the average adjusted bases for all assets of the financial institution. This 100% interest expense disallowance rule is relaxed for certain "qualified tax-exempt obligations" (or "**QTEOs**")[18] issued by qualified small issuers (described below). QTEOs owned by financial institutions result in only a 20% interest expense disallowance, rather than the 100% disallowance applicable to other tax-exempt bonds.

The Stimulus Act modifies the interest expense disallowance rule applicable to financial institutions by adding a 2% "*de minimis*" exception and by expanding the category of bonds eligible to be designated as QTEOs. These modifications are designed to improve the marketability of tax-exempt bonds by making them more attractive investments to financial institutions in certain circumstances.

2. De Minimis Exception

The Stimulus Act provides a 2% "*de minimis*" exception for bonds (including private activity bonds) originally issued as new-money bonds in 2009 or 2010 (and any refundings of those bonds either directly or as part of a series of refundings). Bonds eligible for the 2% *de minimis* exception that are owned by a financial institution result in only a 20% interest expense disallowance (similar to QTEOs), rather than the 100% disallowance described above, to the

[17] The Stimulus Act requires the Treasury Department to study the effects of tribal economic development bonds and, within one year after enactment, to submit to Congress a report with the results of the study and any recommendations.
[18] QTEOs are also sometimes referred to as "bank qualified" obligations.

extent the amount of those bonds owned by the financial institution does not exceed 2% of the average adjusted bases for all assets of the financial institution. The Stimulus Act does not address how an issuer might designate a portion of an issue as eligible for the 2% *de minimis* exception in the case of a combined issue in which only some of the bonds qualify (for example, a 2009 issue consisting of new-money bonds and bonds issued to refund obligations issued before 2009).

3. Qualified Tax-exempt Obligations (QTEOs)

As indicated above, qualified tax-exempt obligations, or QTEOs, owned by financial institutions result in only a 20% interest expense disallowance, rather than the 100% disallowance that generally applies to other tax-exempt bonds owned by financial institutions. A "**qualified tax-exempt obligation**" is a tax-exempt obligation that:

(1) is issued after August 7, 1986, by a qualified small issuer;

(2) is not a private activity bond (other than a qualified 501(c)(3) bond);[19] and

(3) is designated by the issuer as a qualified tax-exempt obligation.

Prior to the Stimulus Act, a "**qualified small issuer**" was defined as an issuer that reasonably anticipates that the amount of tax-exempt obligations (other than (1) private activity bonds that are not qualified 501(c)(3) bonds, (2) certain refunding bonds that meet transition requirements in the Tax Reform Act of 1986, and (3) certain current refunding bonds that do not exceed the amount of the refunded bonds) that it will issue during the calendar year will not exceed $10 million. The Stimulus Act increases this $10 million limit to $30 million for bonds issued in 2009 or 2010.

In addition, the Stimulus Act provides that, in the case of any qualified 501(c)(3) bond issued in 2009 or 2010 for the benefit of a tax-exempt hospital, university, or other charitable organization described in section 501(c)(3) of the Code (a "**501(c)(3) organization**"), the 501(c)(3) organization will be treated as the issuer for purposes of determining whether the bonds can be designated as QTEOs. Thus, qualified 501(c)(3) bonds issued in 2009 or 2010 will be eligible for designation as QTEOs if the 501(c)(3) organization for whose benefit the bonds are issued reasonably anticipates that the amount of tax-exempt obligations that will be issued for its benefit during the calendar year will not exceed $30 million. Similarly, qualified 501(c)(3) bonds issued for the benefit of a conduit borrower that is a 501(c)(3) organization will not count against the conduit issuer's $30 million limit. In some cases, if a 501(c)(3) organization uses a bond-financed facility indirectly (for example, as a lessee or manager), it may not be entirely clear whether the organization is the beneficiary and the therefore the issuer of the bond for purposes of determining QTEO status.

Finally, the Stimulus Act expands the types of pooled financing issues that may be designated as QTEOs. Prior to the Stimulus Act, a bond issue that financed two or more loans to

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[19] Certain bonds issued to refund (directly or as part of a series of refundings) obligations issued before August 8, 1986, that were not industrial development bonds, mortgage subsidy bonds, student loan bonds, or private loan bonds under prior law are not treated as private activity bonds for this purpose.

different borrowers was eligible to be designated as QTEOs only if the requirements for QTEO status were met with respect to (1) the entire issue as a whole and (2) each portion of the issue that financed a separate loan. The Stimulus Act relaxes these requirements for "qualified financing issues" issued in 2009 or 2010. A "**qualified financing issue**" is a composite, pooled, or other conduit financing issue the proceeds of which are used to make or finance loans to one or more ultimate borrowers, each of which is a state or local governmental unit or a 501(c)(3) organization (a "**qualified borrower**"). Bonds of a qualified financing issue issued in 2009 or 2010 qualify as QTEOs if each portion of the issue that finances a loan to a qualified borrower meets the requirements for QTEO status, treating each such portion as a separate issue issued by the applicable qualified borrower. Thus, for example, a $100 million pooled financing issue issued in 2009 could qualify as QTEOs if the proceeds of the issue were used to make four equal loans of $25 million to four qualified borrowers. However, if (1) more than $30 million were loaned to any qualified borrower, (2) any borrower was not a qualified borrower, or (3) any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to that borrower, fail to meet any of the other requirements applicable to QTEOs, the entire $100 million pooled financing issue would fail to qualify as QTEOs.

B. Alternative Minimum Tax

Prior to the Stimulus Act, interest on tax-exempt private activity bonds (other than qualified 501(c)(3) bonds and certain single- and multi-family housing bonds) generally was a "tax preference" item for purposes of the federal alternative minimum tax (AMT), and interest on tax-exempt bonds owned by a corporation generally was included in the corporation's adjusted current earnings for purposes of calculating the alternative minimum taxable income of the corporation for AMT purposes. The Stimulus Act provides that interest on the following bonds is not a "tax preference" item and is not included in corporate adjusted current earnings:

(1) bonds originally issued as new-money bonds in 2009 or 2010 (and any refundings of those bonds either directly or as part of a series of refundings); and

(2) refunding bonds issued in 2009 or 2010 to refund bonds that were issued in 2004, 2005, 2006, 2007, or 2008.

The Stimulus Act does not address how an issuer might designate a portion of an issue as eligible for one of the two AMT exemptions described above in the case of a combined issue in which only some of the bonds qualify (for example, a 2009 issue consisting of new-money bonds and bonds issued to refund obligations issued before 2004).

C. Bonds Held by Mutual Funds or REITs

The Stimulus Act and prior law contain provisions relating to mutual funds and real estate investment trusts that could enhance the marketability of qualified tax credit bonds and Tax Credit BABs. In particular, the Treasury Department is authorized to provide guidance under which a mutual fund that holds a qualified tax credit bond or a Tax Credit BAB may elect to pass through to its shareholders their proportionate shares of tax credits and associated interest income from the bond. The Treasury Department is also authorized to prescribe procedures under which a real estate investment trust that holds any such bond could pass through to its beneficiaries the tax credits and associated interest income from the bond.

VII. Considerations Applicable to Taxable Bonds and Tax Credits

A. Davis-Bacon Requirements

The federal Davis-Bacon prevailing wage requirements apply to projects financed with the following bonds issued after February 17, 2009: (1) Recovery Zone Economic Development BABs (but not other types of BABs); (2) Qualified School Construction Bonds; (3) Qualified Zone Academy Bonds; (4) New CREBs; and (5) Qualified Energy Conservation Bonds. Accordingly, if an issuer issues any of these types of bonds, it must pay, or assure that contractors pay, on-site project workers no less than the locally prevailing wages and benefits paid on similar projects, to the same extent as a project with substantial federal assistance. The Davis-Bacon Act requires contractors to pay workers on federally funded work at least the "prevailing wage." The prevailing wage is determined for classes of workers in the locale of the work by the United States Department of Labor and may be different (and is often higher) than the prevailing wage set by a state or local government under a state prevailing wage law. Depending upon the type of work involved, a general wage determination may be applicable, or it may be necessary to obtain a wage determination for the particular project. The contract documents must require the general contractor and all subcontractors to comply. Accordingly, Davis-Bacon provisions must be included in bid documents for projects to be financed by affected qualified tax credit bonds and Recovery Zone Economic Development BABs. Contract documentation generally authorizes the owner to cancel the contract due to non-compliance, with the contractor being required to pay any extra costs required to complete. Our labor and employment attorneys counsel clients on Davis-Bacon issues and can answer questions or provide compliance assistance for affected projects.

Davis-Bacon requirements are not an express condition to the tax credit or interest subsidy, so it is unclear whether failure to comply would result in a loss of the credit or subsidy.

B. Revenue Bond Considerations

If Direct Subsidy BABs (or Recovery Zone Economic Development BABs) are to be issued as utility system revenue bonds, issuers should consider possible implications for covenant compliance, additional bonds tests, and diversions from the enterprise fund to the general fund. Unless the federal subsidy is included in the "revenue" of the "system," it may not be counted in complying with the issuer's rate covenant or the debt service coverage condition to its right to issue additional parity bonds, and the subsidy may be credited to the issuer's general fund, rather than the system revenue fund. In addition, the gross amount of interest on the BABs will likely be included in the issuer's annual debt service requirements for these purposes. Accordingly, if an issuer issues Direct Subsidy BABs (or Recovery Zone Economic Development BABs) rather than tax-exempt bonds or Tax Credit BABs to finance improvements to its utility system, the system's debt service coverage could be diluted, even if net debt service on Direct Subsidy BABs is less, and the system's subsidy of the general fund could be increased.

C. Combining BABs or Qualified Tax Credit Bonds with Tax-exempt Bonds

Issuers may wish to issue some combination of BABs, qualified tax credit bonds, and/or traditional taxable or tax-exempt bonds as part of the same financing due to, for example, limits on maturities or uses of proceeds applicable to some of the bonds or market factors such as spreads between taxable and tax-exempt interest rates at different points on the yield curve. In these situations, it will be important to determine which bonds are part of the same "issue" for purposes of arbitrage, private business use, and other federal tax limits. Treasury Regulations indicate that taxable and tax-exempt bonds are not part of the same issue for purposes of the tax-exempt bond rules, although detailed guidance specifically applicable to BABs or qualified tax credit bonds has not yet been provided.[20] Absent guidance, there may be some risk that bonds could be considered part of the same issue for purposes of complying with the conditions to receiving tax credits or other federal subsidies even when considered separate under tax-exempt bond regulations.

D. Market for Taxable Bonds

Although taxable tax credit bonds have been authorized since 1997, they have been issued in relatively small amounts for limited purposes, so we understand that a substantial market for tax credit bonds has not yet been established. For that reason, and due to reductions in the taxable income of investors associated with the current economic downturn, many expect that a substantial efficient market for tax credit bonds is not likely to develop before regulations are released to authorize stripping and separate trading of the tax credits.

It is expected that Direct Subsidy BABs and stripped tax credit bonds could be sold in new markets to investors who, because not fully subject to federal income taxes, have not traditionally purchased tax-exempt bonds or tax credit bonds. Possible new investors include pension funds, state and local governments, public and non-profit endowments, corporations with taxable losses and loss carryforwards (or capped by the 2% *de minimis* rule from further tax-exempt bond purchases), banks, and foreign investors, including sovereign wealth funds. Accordingly, these bonds may be issued in overseas markets and denominated in Euros or other non-U.S. currencies. We have assembled a team of public finance, corporate finance, and project finance lawyers to advise issuers, underwriters, and others on the legal requirements for such offerings, including Shari'a compliant financings.

Conventions of the existing market for taxable bonds could present challenges to issuers, unless the market evolves. Taxable debt issues are generally sold in substantially larger offerings than the average tax-exempt bond offering. (It is possible that borrowing through bond banks will increase in order to achieve issue sizes needed to access the taxable bond market.) Taxable bonds and notes are generally sold as term instruments with no (or only short) sinking fund redemption provisions, in contrast to largely serial tax-exempt bond offerings. In addition, taxable bonds are generally not callable at the issuer's option, or are callable only upon payment of a make-whole premium, *i.e.*, a premium that results in the same return on investment if the

[20] Notice 2009-29 (relating to Qualified Energy Conservation Bonds), Notice 2009-33 (relating to New CREBs), and Notice 2009-35 (relating to Qualified School Construction Bonds) indicate that the regulatory definition of "issue" applicable to tax-exempt bonds will apply to these qualified tax credit bonds for information reporting and possibly some other purposes.

redemption price is reinvested at then prevailing interest rates. Accordingly, issuers should consult with their financial advisors and counsel to develop strategies for achieving their financing goals (including complying with the surplus proceeds redemption requirements applicable to qualified tax credit bonds) without undue pricing or marketing impact. Our corporate finance lawyers are on call to share their experience in the taxable corporate bond market.

E. Separate Trading of Tax Credits

When and if tax credits become strippable, a mechanism will have to be developed in most (or all) cases to provide for the registration of transfers of the tax credits. Unless DTC develops a mechanism for depositing and transferring tax certificates, it is likely that tax credit bonds will need to be issued in certificated form with appurtenant tax credit certificates that, after the issuance of regulations, are detachable and separately transferable through a registration process maintained by a trustee, paying agent, or other registrar. If the bonds are callable (*e.g.*, to comply with the surplus proceeds redemption provisions for qualified tax credit bonds or to qualify for remedial action authorized by tax regulations), then tax credits for payment dates subsequent to the first permitted call date must be provisional, similar to interest coupons appertaining to callable bearer bonds issued before 1983.

F. Circular 230

IRS Circular 230 generally requires that written opinions on federal tax matters either address certain issues or contain a specified disclaimer. Opinions relating to tax-exempt bonds, and qualified zone academy bonds authorized under prior law that are not qualified tax credit bonds, are excepted from this requirement. Absent further guidance, it appears that qualified tax credit bonds, as well as Tax Credit BABs and Direct Subsidy BABs, are not eligible for the exception. Consequently, bond counsel opinions will need to comply with Circular 230, either increasing the cost to issuers or excepting the opinion from penalty protection.

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Fulbright & Jaworski's Public Finance Practice Group

Fulbright & Jaworski's Public Finance Practice Group collaborates with clients to help them achieve their objectives in the municipal securities marketplace. Our municipal securities practice annually ranks as one of the most active in the nation. In 2008, Fulbright & Jaworski ranked 5th in the nation as bond counsel helping to raise more than $11.5 billion in capital in more than 260 municipal securities offerings.

Our attorneys have extensive experience as counsel to issuers of tax-exempt obligations and as counsel to their underwriters, credit enhancers, derivatives dealers and liquidity providers.

Issuers of municipal obligations look to the Public Finance attorneys at Fulbright & Jaworski as bond, disclosure, swap counsel and general counsel for:

- States and territories
- Municipalities
- Counties
- Schools
- Special purpose districts
- Correctional facilities
- Health care facilities
- Public-private partnerships
- Higher education facilities
- Student loans
- Housing
- Land development infrastructure
- Environmental facilities
- Economic and industrial development
- Special facilities: sports stadiums and convention centers
- Public power

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or tax-related matter[s].

APPENDIX A
VOLUME CAP ALLOCATIONS

Qualified Energy Conservation Bonds[21]

State or Territory	QECB Allocation (in dollars)
Alabama	48,364,000
Alaska	7,120,000
Arizona	67,436,000
Arkansas	29,623,000
California	381,329,000
Colorado	51,244,000
Connecticut	36,323,000
Delaware	9,058,000
District of Columbia	6,140,000
Florida	190,146,000
Georgia	100,484,000
Hawaii	13,364,000
Idaho	15,809,000
Illinois	133,846,000
Indiana	66,155,000
Iowa	31,150,000
Kansas	29,070,000
Kentucky	44,291,000
Louisiana	45,759,000
Maine	13,657,000
Maryland	58,445,000
Massachusetts	67,413,000
Michigan	103,780,000
Minnesota	54,159,000
Mississippi	30,486,000
Missouri	61,329,000
Montana	10,037,000
Nebraska	18,502,000
Nevada	26,975,000
New Hampshire	13,651,000
New Jersey	90,078,000
New Mexico	20,587,000
New York	202,200,000
North Carolina	95,677,000
North Dakota	6,655,000
Ohio	119,160,000
Oklahoma	37,787,000
Oregon	39,320,000

[21] Source: Notice 2009-29.

State or Territory	QECB Allocation (in dollars)
Pennsylvania	129,144,000
Rhode Island	10,901,000
South Carolina	46,475,000
South Dakota	8,343,000
Tennessee	64,476,000
Texas	252,378,000
Utah	28,389,000
Vermont	6,445,000
Virginia	80,600,000
Washington	67,944,000
West Virginia	18,824,000
Wisconsin	58,387,000
Wyoming	5,526,000
American Samoa	673,000
Guam	1,826,000
Northern Marianas	899,000
Puerto Rico	41,021,000
U.S. Virgin Islands	1,140,000
Total Allocation	3,200,000,000

Qualified School Construction Bonds[22]

2009 Allocations to States (Net of Allocations to Large Local Educational Agencies)

State/Territory	Total Allocation by State/ Territory
Alabama	118,776,000
Alaska	29,784,000
Arizona	186,292,000
Arkansas	113,443,000
California	773,525,000
Colorado	87,147,000
Connecticut	105,092,000
Delaware	29,784,000
District of Columbia	0
Florida	106,806,000
Georgia	201,062,000
Hawaii	0
Idaho	37,665,000
Illinois	244,435,000
Indiana	177,861,000
Iowa	64,252,000
Kansas	79,589,000
Kentucky	135,132,000
Louisiana	131,622,000
Maine	42,074,000
Maryland	50,354,000
Massachusetts	144,783,000
Michigan	296,860,000
Minnesota	75,850,000
Mississippi	132,443,000
Missouri	141,441,000
Montana	31,623,000
Nebraska	32,343,000
Nevada	6,767,000
New Hampshire	29,784,000
New Jersey	223,279,000
New Mexico	64,602,000
New York	192,049,000
North Carolina	187,167,000
North Dakota	25,740,000
Ohio	267,112,000

[22] Source: Notice 2009-35.

State/Territory	Total Allocation by State/ Territory
Oklahoma	87,018,000
Oregon	112,886,000
Pennsylvania	315,737,000
Rhode Island	22,062,000
South Carolina	131,364,000
South Dakota	29,784,000
Tennessee	121,738,000
Texas	538,585,000
Utah	50,962,000
Vermont	24,845,000
Virginia	191,077,000
Washington	164,111,000
West Virginia	78,219,000
Wisconsin	98,589,000
Wyoming	24,080,000
American Samoa	10,748,000
Guam	10,980,000
Northern Marianas	10,703,000
Puerto Rico	0
U.S. Virgin Islands	9,974,000
Total	6,600,000,000

Qualified School Construction Bonds (Cont'd)[23]

2009 Allocations to Large Local Educational Agencies

State	Large Local Educational Agency	Allocation
Alabama	Birmingham City School District	15,683,000
Alabama	Mobile County School District	23,135,000
Alabama	Montgomery County School District	11,421,000
Arizona	Mesa Unified District	16,111,000
Arizona	Tucson Unified District	21,375,000
California	Bakersfield City Elementary	15,720,000
California	Compton Unified	18,559,000
California	Fresno Unified	41,398,000
California	Long Beach Unified	37,905,000
California	Los Angeles Unified	318,816,000
California	Oakland Unified	26,326,000
California	Sacramento City Unified	21,251,000
California	San Bernardino City Unified	27,790,000
California	San Diego City Unified	38,877,000
California	Santa Ana Unified	19,269,000
California	Stockton City Unified	16,055,000
Colorado	Denver County 1	24,022,000
District of Columbia	District of Columbia Public Schools	33,936,000
Florida	Broward County School District	49,913,000
Florida	Dade County School District	104,855,000
Florida	Duval County School District	27,220,000
Florida	Hillsborough County School District	40,633,000
Florida	Lee County School District	12,701,000
Florida	Orange County School District	35,824,000
Florida	Palm Beach County School District	33,643,000
Florida	Pasco County School District	11,028,000
Florida	Pinellas County School District	24,352,000
Florida	Polk County School District	20,543,000
Florida	Volusia County School District	11,941,000
Georgia	Atlanta City School District	37,934,000
Georgia	Clayton County School District	13,793,000
Georgia	Cobb County School District	12,732,000
Georgia	De Kalb County School District	27,832,000
Georgia	Fulton County School District	17,720,000
Georgia	Gwinnett County School District	18,985,000
Georgia	Richmond County School District	16,163,000
Hawaii	Hawaii	32,058,000

[23] Source: Notice 2009-35.

State	Large Local Educational Agency	Allocation
Illinois	City of Chicago School District 299	254,250,000
Indiana	Indianapolis Public Schools	31,181,000
Kentucky	Jefferson County School District	27,483,000
Louisiana	Caddo Parish School Board	17,359,000
Louisiana	East Baton Rouge Parish School Board	21,433,000
Louisiana	Jefferson Parish School Board	21,646,000
Louisiana	Orleans Parish School Board	39,607,000
Maryland	Baltimore City Public School System	58,096,000
Maryland	Baltimore County Public Schools	19,424,000
Maryland	Prince George’s County Public Schools	25,102,000
Massachusetts	Boston	37,567,000
Massachusetts	Springfield	17,864,000
Michigan	Detroit City School District	123,272,000
Minnesota	Minneapolis	21,739,000
Minnesota	St. Paul	16,119,000
Mississippi	Jackson Public School District	15,255,000
Missouri	Kansas City School District	17,880,000
Missouri	St Louis City	28,163,000
Nebraska	Omaha Public Schools	17,378,000
Nevada	Clark County School District	51,414,000
New Jersey	Newark City	27,258,000
New Mexico	Albuquerque Public Schools	21,968,000
New York	Buffalo City School District	34,374,000
New York	New York City	699,872,000
New York	Rochester City School District	29,535,000
North Carolina	Charlotte-Mecklenburg Schools	25,962,000
North Carolina	Cumberland County Schools	15,948,000
North Carolina	Forsyth County Schools	12,244,000
North Carolina	Guilford County Schools	17,147,000
North Carolina	Wake County Schools	17,304,000
Ohio	Akron City School District	15,062,000
Ohio	Cincinnati City School District	25,632,000
Ohio	Cleveland Municipal School District	53,145,000
Ohio	Columbus City School District	36,372,000
Ohio	Toledo City School District	21,460,000
Oklahoma	Oklahoma City	17,844,000
Oklahoma	Tulsa	14,327,000
Pennsylvania	Philadelphia City School District	146,897,000
Puerto Rico	Puerto Rico	376,055,000
Rhode Island	Providence School District	22,338,000
South Carolina	Charleston County School District	13,517,000
South Carolina	Greenville County School District	15,060,000
Tennessee	Memphis City School District	41,736,000
Tennessee	Nashville-Davidson County School District	21,132,000

State	Large Local Educational Agency	Allocation
Texas	Aldine Independent School District	18,810,000
Texas	Alief Independent School District	16,297,000
Texas	Arlington Independent School District	12,805,000
Texas	Austin Independent School District	24,440,000
Texas	Brownsville Independent School District	25,612,000
Texas	Dallas Independent School District	73,741,000
Texas	Edinburg Consolidated Independent School District	13,810,000
Texas	El Paso Independent School District	29,067,000
Texas	Fort Worth Independent School District	31,602,000
Texas	Garland Independent School District	10,186,000
Texas	Houston Independent School District	94,303,000
Texas	La Joya Independent School District	13,392,000
Texas	Laredo Independent School District	13,639,000
Texas	Northside Independent School District	13,299,000
Texas	Pasadena Independent School District	14,445,000
Texas	Pharr-San Juan-Alamo Independent School District	13,302,000
Texas	San Antonio Independent School District	30,385,000
Texas	Ysleta Independent School District	16,807,000
Wisconsin	Milwaukee	72,118,000
Total		4,400,000,000

Qualified Zone Academy Bonds (2008)[24]

State or Territory	QZAB Allocations (in dollars)
Alabama	7,606,000
Alaska	600,000
Arizona	8,817,000
Arkansas	4,924,000
California	44,364,000
Colorado	5,694,000
Connecticut	2,692,000
Delaware	881,000
District of Columbia	921,000
Florida	21,607,000
Georgia	13,250,000
Hawaii	1,001,000
Idaho	1,781,000
Illinois	14,972,000
Indiana	7,586,000
Iowa	3,182,000
Kansas	3,002,000
Kentucky	7,145,000
Louisiana	7,756,000
Maine	1,541,000
Maryland	4,543,000
Massachusetts	6,215,000
Michigan	13,781,000
Minnesota	4,824,000
Mississippi	5,824,000
Missouri	7,426,000
Montana	1,321,000
Nebraska	1,931,000
Nevada	2,702,000
New Hampshire	901,000
New Jersey	7,296,000
New Mexico	3,493,000
New York	25,720,000
North Carolina	12,600,000
North Dakota	741,000
Ohio	14,651,000
Oklahoma	5,574,000
Oregon	4,744,000
Pennsylvania	13,941,000

[24] Source: Notice 2009-30.

State or Territory	QZAB Allocations (in dollars)
Rhode Island	1,221,000
South Carolina	6,425,000
South Dakota	1,011,000
Tennessee	9,547,000
Texas	37,939,000
Utah	2,512,000
Vermont	610,000
Virginia	7,436,000
Washington	7,256,000
West Virginia	2,982,000
Wisconsin	5,885,000
Wyoming	440,000
American Samoa	391,000
Guam	399,000
Northern Mariana Islands	389,000
Puerto Rico	17,644,000
U.S. Virgin Islands	363,000
Total Allocation	400,000,000

Qualified Zone Academy Bonds (2009)[25]

State or Territory	QZAB Allocations (in dollars)
Alabama	26,621,000
Alaska	2,102,000
Arizona	30,859,000
Arkansas	17,233,000
California	155,275,000
Colorado	19,930,000
Connecticut	9,422,000
Delaware	3,082,000
DC	3,222,000
Florida	75,623,000
Georgia	46,376,000
Hawaii	3,503,000
Idaho	6,235,000
Illinois	52,401,000
Indiana	26,551,000
Iowa	11,139,000

[25] Source: Notice 2009-30.

State or Territory	QZAB Allocations (in dollars)
Kansas	10,508,000
Kentucky	25,009,000
Louisiana	27,146,000
Maine	5,394,000
Maryland	15,902,000
Massachusetts	21,752,000
Michigan	48,232,000
Minnesota	16,883,000
Mississippi	20,386,000
Missouri	25,990,000
Montana	4,624,000
Nebraska	6,760,000
Nevada	9,457,000
New Hampshire	3,152,000
New Jersey	25,535,000
New Mexico	12,224,000
New York	90,020,000
North Carolina	44,099,000
North Dakota	2,592,000
Ohio	51,280,000
Oklahoma	19,510,000
Oregon	16,603,000
Pennsylvania	48,793,000
Rhode Island	4,273,000
South Carolina	22,487,000
South Dakota	3,538,000
Tennessee.	33,416,000
Texas	132,788,000
Utah	8,792,000
Vermont	2,137,000
Virginia	26,025,000
Washington	25,395,000
West Virginia	10,438,000
Wisconsin	20,596,000
Wyoming	1,541,000
American Samoa	1,368,000
Guam	1,397,000
Northern Mariana Islands	1,362,000
Puerto Rico	61,753,000
U.S. Virgin Islands	1,269,000
Total Allocation	1,400,000,000